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# In the Supreme Court of the United States

OCTOBER TERM, 1959

R. C. OWEN COMPANY, PETITIONER

*v.*

UNITED STATES OF AMERICA

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS*

## BRIEF FOR THE UNITED STATES IN OPPOSITION

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## BRIEF FOR THE UNITED STATES IN OPPOSITION

### OPINION BELOW

The opinion of the Court of Claims (R. 23–38; Pet. 11–30) is reported at 180 F. Supp. 369.

### JURISDICTION

The judgment of the Court of Claims was entered February 3, 1960. (R. 38; Pet. 11, 29–30). The petition for a writ of certiorari was filed on March 26, 1960. The jurisdiction of this Court is invoked under 28 U.S.C. 1255(1).

### QUESTION PRESENTED

Whether the Court of Claims correctly found that a family corporation's alleged debentures in fact represented capital investments rather than bona fide

indebtedness, and that interest paid thereon was therefore not deductible under the Internal Revenue Code as interest on indebtedness.

## STATUTES INVOLVED

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter.

* * * * *

(26 U.S.C. 1952 ed., Sec. 23.)

Internal Revenue Code of 1954:

SEC. 163. INTEREST.

(a) *General Rule.*—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

* * * * *

(26 U.S.C. 163.)

## STATEMENT

The findings of fact of the Court of Claims (R. 28–37; Pet. 18–29) are undisputed (Pet. 3). The pertinent facts may be summarized as follows:

In 1946 taxpayer, a corporation, was organized to and did acquire the business and assets of a family

partnership known as R. C. Owen, Manufacturers of Tobacco. The father, R. C. Owen, had owned a 72% interest in the partnership, and his two sons, R. C. Owen, Jr. and Roy Owen, 14% each. In return for the business and assets of the partnership, the corporation issued to the partners on December 1, 1946, 35,000 shares of $1 par value common stock and $800,000 of so-called debentures. The stock and debentures were issued to the partners in the same proportion as their prior interests in the partnership. (Pet. 18, 20.)

Among the reasons for the transfer of the business from the partnership to the corporation, and the capitalization of the latter, was the desire of R. C. Owen (approved by his sons) to assure the continuation of family control of the business against the hazards (1) of dissolution of the partnership (under Tennessee law) upon the death of a partner and (2) of loss of control of the business in the raising of substantial amounts of cash with which to pay inheritance taxes upon the death of R. C. Owen. It was the senior Owen's belief (shared by his sons) that the so-called debentures could be sold, if necessary, to provide the requisite cash; and thereby permit retention of the capital stock by the two partner-sons and the other four children of R. C. Owen, all of whom were to share in his estate through a trust indenture subsequently executed. (Pet. 19–20.)

In November, 1947, in order to place control of the corporation in his sons, R. C. Owen gave 4,000 shares of stock to each son in return for $4,000 in so-called debentures. The effect of this exchange was to give

the two sons together 50.86% of the outstanding shares. Subsequently, he placed his remaining shares of stock in a trust for the benefit of his six children. He retained the so-called debentures (in the principal amount of $584,000), upon which he has since received annual income of $20,440. He also continued to serve as chairman of the board. (Pet. 20–22.)

The debentures mature in twenty years; bear interest at 3½% payable semiannually; and are callable during the first ten years at 101% and thereafter at par, plus accrued and unpaid interest. They provide that until paid in full, the company will not place any liens on its property (with a minor exception) and will maintain certain net current assets; that the debentures are subordinate to "any and all indebtedness" incurred by the company "to banks or to others in the ordinary course of business"; that "[a]ny and all provisions and agreements" thereof "may be changed, altered, or amended" by written vote of the holders of 75% of the principal amount thereof; and that upon default the holders of 75% may declare the entire issue due and payable. (Pet. 22–24.)

Taxpayer has paid the interest on the so-called debentures and there has been no default in any of the latter's terms and conditions. (Pet. 24.)

The balance sheet of the corporation as of December 1, 1946, showed assets of $1,090,245.26, including intangibles (good will) of $14,351.30, inventories of $581,602.63 (principally raw tobacco), and fixed assets of $300,836.31; current liabilities of $255,245.26; funded debt (the so-called debentures here in controversy) of $800,000; and capital account of $35,000,

consisting of the 35,000 shares of one dollar par value stock. (Pet. 14, 21.)

From December 1, 1946 through April 30, 1956, the taxpayer added all net profits to earned surplus. No dividends were paid on the common stock. (Pet. 24.)

Taxpayer took as an income deduction for the years 1953 through 1955 the amount of interest paid on the debentures. The Commissioner of Internal Revenue disallowed the deductions, on the ground that "the so-called debentures did not represent bona fide indebtedness," and assessed a deficiency for each of those years of $14,560. (Pet. 11.) Taxpayer paid the assessment and then instituted the instant suit for refund.

The Court of Claims sustained the Commissioner's ruling (Pet. 14) and dismissed the suit (Pet. 18). It held (Pet. 17–18) that it was "clear to us that the $800,000.00 represented by so-called debentures, in the formation of the corporation, definitely constituted contributions to capital, or capital investments on the part of the partners, rather than indebtedness. Hence, the periodic payments to the debenture holders were not deductible as interest on indebtedness * * *." It stated (Pet. 16) that although the debentures "have some of the indicia of evidences of debt * * * they have numerous other characteristics more indicative of contributions to capital, *i.e.*, capital stock." The latter characteristics included the following: (1) the partners loaned no money nor paid anything to the corporation for the debentures, which were issued in precisely the same proportion as the partners' respective interests in the partnership; (2)

the debentures were subordinated to "any and all indebtedness incurred" by the corporation, "a characteristic of common stock"; (3) the debenture holders "acquired certain voting rights not ordinarily characteristic of debentures," for instance, upon default the debentures could be declared due and payable only upon the vote of 75% of the holders thereof, and 75% of such holders might change "all provisions and agreements" thereof; (4) although the father, the principal owner of the business, had completely divested himself of any stock interest in the corporation in December 1957, and held only the debentures, he continued as chairman of the Board of Directors and thus "actually, he was very much in control, although his entire stake in the business was in the form of debenture ownership"; (5) the company's equity capital of $35,000.00 was "entirely disproportionate" in a business with a funded debt of $800,000.00 and current liabilities of $255,245.26; and (6) although the company prospered during the years, no dividends were paid on the common stock, and all returns to the owners of the business were "in the form of interest on the debentures" (Pet. 16–17).

## ARGUMENT

This Court has pointed out that "[t]here is no one characteristic, not even exclusion from management, which can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts. So-called stock certificates may be authorized by corporations which are really debts, and promises to pay may be executed which

have incidents of stock". *John Kelley Co. v. Commissioner,* 326 U.S. 521, 530. Thus, in order "to determine whether particular payments are interest and deductible by the payor in computing its income taxes, or dividends, and, therefore, nondeductible by the payor, it is necessary to look at all of the terms and provisions of the particular security, the purpose for which it was issued, the surrounding circumstances and the general intention of the parties." (*Lee Telephone Co. v. Commissioner,* 260 F. 2d 114, 115 (C.A. 4)). Of necessity, therefore, the determination whether "the obligations are risk investments * * * or debts" (*Kelley, supra*) depends upon the facts of each particular case. We submit that the Court of Claims' decision that these particular debentures in fact had more of the characteristics of "risk investments" than "debts" is fully supported by the uncontested findings, and that there is no occasion for further review of this factual question.

In the first place, as the court below noted (Pet. 16), no money was loaned to the taxpayer by the recipients of the debentures. The debentures were issued in precisely the same proportion as the partners' respective interest in the partnership, and the transaction obviously involved only the substitution of the debentures for the risk capital that the members of the Owen family had invested in the partnership. Moreover, as the court below held (Pet. 16-17), the securities themselves had several features more characteristic of capital stock than debt. Of course, the fact that the securities are called debentures is not conclusive. *Kelley, supra; Gregory* v.

*Helvering,* 293 U.S. 465; *Crawford Drug Stores* v. *United States,* 220 F. 2d 292, 296 (C.A. 10); *Rowan* v. *United States,* 219 F. 2d 51 (C.A. 5). Among the characteristics of common stock which the debentures possessed were that they were subordinated to "any and all indebtedness" of the corporation, and that their owners acquired voting rights not ordinarily found in true debt securities. For example, even upon default the debentures could be declared due and payable only upon the vote of 75% of the holders thereof. As a practical matter, therefore, there was no fixed right to payment in the event of default—an indication of the absence of a true indebtedness. See *Equitable Society* v. *Commissioner,* 321 U.S. 560; *Staked Plains Trust* v. *Commissioner,* 143 F. 2d 421 (C.A. 5).

The extremely high ratio of debt to capital stock investment is further indication that the debentures did not represent bona fide indebtedness. *Cf. Kelley, supra,* 326 U.S. at 526. Finally, it is significant that although the company prospered during the years in question, no dividends were paid on the common stock, and all the returns to the owners of the business were in the form of interest payments.

Contrary to petitioner's contention (Pet. 8–10), the decision below is not in conflict with *Rowan* v. *United States,* 219 F. 2d 51 (C.A. 5), *Kraft Foods Co.* v. *Commissioner,* 232 F. 2d 118 (C.A. 2), or *Miller's Estate* v. *Commissioner,* 239 F. 2d 729 (C.A. 9). Those cases did not apply any different principles than were applied by the court below, and the reason interest payments were not disallowed there

was because of the significantly different factual situations involved.

## CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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